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An Overview of Commercial Mortgage Backed Securitization: The Devil Is in the Details

Alan Kronovet

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I. INTRODUCTION

"Commercial real estate is income-producing properties that are managed for economic profit,"[1] such as apartments, shopping centers, hotels, restaurants, warehouses, and offices.[2] It is estimated that an excess of one trillion dollars in outstanding loans is secured by commercial real estate.[3] Commercial real estate lending is the latest financing arrangement to use securitization as an alternative financing structure.

Securitization is the process by which financial assets that generate a cash flow, such as home mortgages, automobile loans, credit card receivables, tax liens, or commercial real estate loans, are converted into securities in order to gain access to the capital markets.[4] Securitization takes illiquid assets and transforms them into marketable securities.[5] The securities issued can be either stocks (equity) or bonds (debt).[6] Like most securities, the securities offered through securitization are transferable, and the only limitation on transferability is the development and activity of the secondary market.[7] Through the use of securitization, banks continue to play a dominate role in commercial real estate lending while shifting the risk of com-

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1. David P. Jacob & Kimbell R. Duncan, *Commercial Mortgage-Backed Securities*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 491, 491 (Frank J. Fabozzi ed., 4th ed. 1995).

2. *See id.*

3. *See* David S. Schaeffer, *A Jump-Start for the Mortgage-Backed Market?*, AM. BANKER, Oct. 24, 1995, at 38.

4. *See* David Alan Richards, *"Gradable and Tradable": The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99 (1987); *see also* Joseph C. Shenke & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373-74 (1991).

5. *See* Franklin D. Sreyer, *Statements to Congress*, 77 FED. RES. BULL. 726, 726 (1991); *see also* Shenke & Colletta, *supra* note 4, at 1373-74.

6. *See* Shenke & Colletta, *supra* note 4, at 1374-75. The needs of the institution offering the security and the acceptance on the marketplace will help determine the type of security instrument offered.

7. *See id.* at 1373. A secondary market is created by the trading of securities between the owners of the securities who are not the issuers and the third party purchasers (who could be the issuers of the security).

mercial real estate loans to third party investors.

Commercial Mortgaged Backed Securitization (CMBS) is the merging of traditional commercial real estate financing and asset backed structured financing.[8] CMBS combines the tools of real estate law with the instruments of securities law.[9] In a commercial real estate securitization conduit, a number of mortgages are originated,[10] pooled, and sold to a special purpose vehicle (SPV).[11] Once the loans are pooled, a national rating agency evaluates the investment risk of the pool.[12] The SPV then divides the pool into separate classes.[13] Once the pool is divided into the separate classes, the SPV sells an interest in the classes to third party investors.[14]

Three primary advantages to securitization exist. First, securitization offers access to investment capital that was traditionally unavailable.[15] Second, securitization reduces bankruptcy risk by segregating the assets securitized from the entity originating the asset.[16] Third, securitization offers flexibility to the issuer by allowing the inclusion of assets that have different cash flow and maturity characteristics.[17]

However, there are three significant criticisms of securitization. First, the creditors of the originating entity lose valuable assets if that entity goes into bankruptcy.[18] Second, the structures of the transaction are so complex that an investor may be unaware of all the potential risks involved with such an investment.[19] Finally, as a corollary to the complexity of the transaction, the investor may not fully

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8. *See* Richards, *supra* note 4, at 122.

9. *See id.*

10. *See infra* notes 95-112 and accompanying text.

11. *See infra* notes 216-44 and accompanying text.

12. *See infra* notes 187-95 and accompanying text.

13. *See infra* notes 59-66 and accompanying text.

14. *See infra* notes 113-47 and accompanying text.

15. *See Structured Financing Techniques*, 50 BUS. LAW. 528, 530-31 (1995); *see also* John C. Cody, Comment, *The Dysfunctional "Family Resemblance" Test: After* Reves v. Ernst & Young, *When are Mortgage Notes "Securities"?*, 42 BUFF. L. REV. 761, 764 (1994). The creation of a secondary market assisted in eliminating the mismatch between lenders' supply of mortgage funds and the demand by borrowers for those funds. *See id.*; *see also* Richards, *supra* note 4, at 103.

16. *See Structured Financing Techniques*, *supra* note 15, at 530. For further discussion, see *infra* notes 216-44 and accompanying text.

17. *See id.* at 531. Cash flow means the amount of cash the asset generates. Maturity characteristics generally deal with the scheduled end of the cash flow of the asset.

18. *See id.* at 535-36.

19. *See id.* at 536.

understand the role of the national rating agencies, such as Standard and Poor's and Moody's Investors Services, and the reliance of the rating agencies on legal opinion to establish the security's rating.[20]

Despite these criticisms, securitization has become a valuable alternative financing source in commercial real estate lending. Securitization is a method of financing that meets the needs of both the asset originator and the investor, and as such, it will continue to expand as a financing alternative. However, the devil of CMBS is in the details.

This Comment exorcises the devil. First, this Comment explores the origins of securitization as a form of financing and the Resolution Trust Corporation's (RTC) role in the rise of CMBS.[21] Further, this Comment explores the basic structure of CMBS transactions from both the origination component[22] and the securities component.[23] Next, this Comment discusses the challenges that faced the viability of the CMBS market and the market response to those challenges.[24] This Comment will also look at the participation of North Carolina banks in the CMBS market. Specifically, this Comment will investigate how First Union National Bank (First Union)[25] and NationsBank, N.A. (NationsBank)[26] integrate CMBS into their commercial real estate lending strategies. In addition, this Comment will evaluate the investment strategies of Branch Banking & Trust Company (BB&T), Central Carolina Bank & Trust Company (CCB), Centura Bank Company (Centura) and Wachovia National Bank & Trust Company (Wachovia) to determine if commercial mortgage backed securities are part of their investment portfolio and the reasons for that decision.[27] Finally, this Comment concludes by identifying specific economic or legal factors that will greatly impact the future of CMBS.[28]

20. *See id.*
21. *See infra* notes 29-94 and accompanying text.
22. *See infra* notes 95-112 and accompanying text.
23. *See infra* notes 113-47 and accompanying text.
24. *See infra* notes 148-244 and accompanying text.
25. *See infra* notes 246-50 and accompanying text.
26. *See infra* notes 251-57 and accompanying text.
27. *See infra* notes 258-64 and accompanying text.
28. *See infra* note 265 and accompanying text.

II. ORIGINS OF SECURITIZATION

With the advent of mortgage insurance programs at the Federal Housing Administration (FHA) in 1934 and the Veterans Administration (VA) in 1944, Congress created a mechanism to insure lenders against residential mortgage defaults.[29] These loan insurance programs had a profound effect on home mortgage lending.[30] The ability of lenders to seek recourse against either the FHA or the VA if a borrower defaulted on a home mortgage increased lender confidence, which increased the possibility of individual homeownership.[31] Furthermore, these programs led to lower down payment requirements and longer term fixed rate mortgages sought by purchasers.[32] All of these factors made homeownership more accessible to potential homebuyers.[33]

Congress then created the Federal National Mortgage Association (FNMA or Fannie Mae) to purchase FHA-insured and VA-guaranteed loans from lenders' portfolios, thereby creating the necessary liquidity to encourage lenders to increase residential mortgage lending.[34] In 1968, FNMA split into two distinct entities.[35] The first entity became a federally chartered corporation owned by private shareholders.[36] This entity continued to be called the Federal National Mortgage Association.[37] The second entity was the Government National Mortgage Association (GNMA or Ginnie Mae), which became a federal agency within the Department of Housing and Urban Development (HUD).[38] Fannie Mae concentrated its efforts on the buying and selling of FHA and VA loans,

29. *See* Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 992 (1986).

30. *See id.*

31. *See id.*

32. *See id.*

33. *See id.* A potential purchaser who is required to put less money down as a deposit for the purchase of a home is able, therefore, to purchase a home more quickly, with less time required to save for a downpayment. Furthermore, longer terms on a fixed rate mortgage and a lower periodic payment allow the purchaser to manage her finances in such a way as to make the purchase of a home more affordable. Finally, the lender assumes very little risk because the FHA or the VA guarantees the loan in the event of a borrower's default. This allows the lender to ease its lending requirements so that an otherwise unqualified borrower might now qualify for a loan.

34. *See id.* at 992-93.

35. *See id.* at 993.

36. *See id.*

37. *See id.*

38. *See id.*

while Ginnie Mae was responsible for the government's special assistance and housing support programs.[39] In 1970, Congress created the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) with the primary goal of purchasing conventional residential mortgage loans.[40] The availability of capital created liquidity in the home mortgage market, which allowed an active secondary market to develop.[41] Uniform lending standards were created for the home mortgage industry due to the continuing development of a sophisticated secondary market.[42]

The size of the active secondary market allowed for the development of new and creative financing techniques. The pooling of residential home mortgages and the offering of securities supported by the pool was the beginning of securitization as an effective financing mechanism.[43] In 1970, GNMA issued the first publicly traded residential mortgage backed securities.[44] These securities were modified pass-through certificates that represented an undivided ownership in a fixed pool of FHA-insured or VA-guaranteed residential mortgages.[45] The undivided interests in the pool were held by a grantor trust for the benefit of pass-through certificate holders.[46] The cash flowing from the underlying mortgages was "passed through" from the trust to the security holder monthly on a pro rata basis.[47] GNMA, using the full faith and credit of the United States as a credit support, guaranteed to its investors the full and timely payment of principal and interest.[48] The Ginnie Mae offerings were soon fol-

39. *See id.* at 993-94.

40. *See id.* at 994. In the statute, conventional loans are those loans that are neither FHA insured nor VA guaranteed in the event of borrower default. *See id.*

41. *See id.*

42. *See id.* Uniformity resulted in the standardization of the mortgage documents that are used for home loan transactions. Thus, the purchaser of loans from the lender or loan originator would not acquire a portfolio of loans with varying terms. This standardization allowed the investor to evaluate the risk of the portfolio as a whole, thereby furthering the development of the secondary market.

43. *See* Richards, *supra* note 4, at 102.

44. *See Structured Financing Techniques*, *supra* note 15, at 537.

45. *See id.*

46. *See id.*

47. *See id.*

48. *See Structured Financing Techniques*, *supra* note 15, at 537; *see also* Richards, *supra* note 4, at 104. In the event of default by any of the mortgagors of the mortgages in the fixed pool, GNMA was obligated to pay the principal and interest to investors. *See* Richards, *supra* note 4, at 104.

lowed by Fannie Mae and Freddie Mac offerings.[49]

Another financing structure that developed was "mortgage-backed bonds" (MBBs).[50] MBBs are general obligations of the issuer in which the issuer keeps the cash flows of the underlying mortgages, and in which the cash flows are not specifically used to pay the bond obligations.[51] Instead, the obligations of the bonds are paid from the issuer's general fund.[52] MBB issuers greatly overcollaterized the bonds in order to attract a more favorable rating, thus allowing the issuer to pay lower interest rates to the bondholders.[53]

A hybrid of the pass-through certificate and MBBs was created with the pay-through bond.[54] Using the best aspects of both the pass-through certificates and mortgage-backed bonds, pay-through bonds linked the interest and principal income of the underlying mortgage pool to the bonds' interest payment obligation.[55] The default risk of the underlying mortgages collateralizing the pool remained with the issuer.[56] Pay-through bonds enabled the issuer to liquidate low-yielding loans without having to write off a capital loss, since the issuer retained ownership of the mortgage collateralizing the bond.[57]

In 1983, Freddie Mac offered the next generation of mortgage backed security, the collateralized mortgage obligation (CMO).[58] The CMO is a pay-through bond divided into multiple classes or tranches[59] that have different maturities.[60] CMOs provide an investor with the opportunity to pick short, intermediate, or long-term maturities.[61] Earlier maturity dates offer the investor lower interest rate yields due to the lower long term interest rate risk.[62] Interest payments are made to each tranche, but the principal is repaid to each

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49. *See* Richards, *supra* note 4, at 104.

50. *See id.* at 106.

51. *See id.*

52. *See id.*

53. *See id.* at 107.

54. *See id.*

55. *See id.*

56. *See id.*

57. *See id.*

58. *See id.* at 108.

59. Taken from the French word "*tranche*," which means "slice." In this context, a tranche is a class of debt securities issued as part of a single debt offering. *See* BARRON'S DICTIONARY OF BANKING TERMS 629 (2d ed. 1993).

60. *See* Richards, *supra* note 4, at 108.

61. *See id.*

62. *See id.*

tranche in succession based on the corresponding maturity.[63] The principal is first repaid to the earliest maturing tranche, and once that tranche is fully repaid, the succeeding tranche begins to receive its principal repayment.[64] However, the exception to this payment schedule is the "Z" tranche. The "Z" tranche, generally the last tranche, receives no interest or principal payment until all the preceding tranches are fully repaid.[65] The "Z" tranche is in reality a Zero Coupon Bond.[66]

The successful securitization of residential mortgages led to the securitization of non-mortgage assets.[67] Early non-mortgage asset securitization centered on commercial paper.[68] However, the market changed significantly in 1985 when the Sperry Corporation (Sperry) issued lease-backed notes.[69] In this transaction, Sperry first created a subsidiary to serve as an entity solely for this securitization transaction.[70] This entity is called a special purpose vehicle (SPV).[71] Sperry then sold its computer operating leases to the SPV, which in turn issued fixed rate notes backed by the pledges of the leases.[72] The cash flow generated by the computer operating leases paid the principal and interest obligations of the notes.[73] The notes offered through the SPV were rated higher than the debt obligations issued by the Sperry.[74]

Soon, other types of receivables were converted into securities. Marine Midland Bank and Valley National Bank began securitizing

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63. *See id.*

64. *See id.*

65. *See id.* at 108.

66. *See id.* The holder of a zero coupon bond receives a lump sum payment at maturity. The bond is sold at a steep discount from its face value because it absorbs the first loss related to the investment. *See* BARRON'S DICTIONARY OF BANKING TERMS 690 (2d ed. 1993). If a borrower is in default, any loss accruing to the investor is first assigned to the holder of the zero coupon bond. Due to the uncertainty of the potential losses in the mortgage pool, the investor pays a steep discount for the bond as a way to potentially receive greater return on a risky investment.

67. *See Structured Financing Techniques*, *supra* note 15, at 538.

68. Commercial paper is a short term promissory note that matures between two days and 270 days from the date of issuing. *See* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 96 (4th ed. 1995).

69. *See Structured Financing Techniques*, *supra* note 15, at 538.

70. *See id.*

71. *See id.*

72. *See id.*

73. *See id.*

74. *See id.*

automobile loans.[75] They were soon followed by General Motors Acceptance Corporation, Chrysler Financial Corporation, and Nissan Motor Acceptance Corporation.[76] In 1987, Bank of America and RepublicBank of Delaware offered credit card receivable-backed securities.[77] Through the late 1980s and into the 1990s, "the list of assets that have been securitized has grown to include municipal leases, mobile home loans, boat loans, non-performing loans, home equity loans, health care receivables, student loans, ... recreational equipment leases," and timber collateralized obligations, as well as other assets.[78]

III. THE ROLE OF THE RESOLUTION TRUST CORPORATION IN THE CREATION OF CMBS

In the late 1980s and early 1990s, traditional providers of debt capital for commercial real estate, such as thrift institutions, banks, and insurance companies, reduced their participation in the financing of commercial real estate due to business considerations or regulatory constraints.[79] This reduction on the part of traditional lenders created an opportunity for the capital markets to provide financing for commercial real estate transactions.[80] In 1984, Olympia & York, a real estate developer, issued a $970 million securitization of three office buildings in New York.[81] This started the use of securitization as a financing mechanism for commercial real estate.[82] However, it was the involvement of the RTC that created the momentum for CMBS.[83] As the RTC took over more failed thrift institutions, it was faced with the issue of what to do with its ever-increasing inventory of commercial real estate assets.[84] The RTC's commercial real estate

75. *See id.*

76. *See id.*

77. *See id.*

78. *Id.* at 539.

79. *See* Jacob & Duncan, *supra* note 1, at 492.

80. *See id.*

81. *See* GREGORY A. WHITE, "SLICING AND DICING" A REVIEW OF COMMERCIAL MORTGAGED-BACKED SECURITIES AND THEIR ROLE IN A PENSION FUND'S INVESTMENT PORTFOLIO 1 (Schroder Mortgage Associates 1994); JULIA C. PARKS ET AL., EXPLORING COMMERCIAL MORTGAGE-BACKED SECURITIES IN A PENSION FUND PORTFOLIO 7 (Heitman/JMB Advisory Corp. 1995).

82. *See* WHITE, *supra* note 81, at 1; *see also* PARKS ET AL., *supra* note 81, at 7.

83. *See* Jacob & Duncan, *supra* note 1, at 492.

84. Brian A. Ciochetti & Timothy J. Riddiough, *Understanding Commercial Mortgage Securitization and Its Impact on Debt Financing for Retail Centers*, 3 J. SHOPPING

inventory contained both performing and non-performing mortgages.[85] The RTC determined that the best course of action was to sell all of its inventory of assets.[86] A question then arose as to *how* to sell these assets.[87] The RTC did not deem traditional auctions a viable alternative because the perceived deflated value of the commercial real estate assets might have led to correspondingly low bidding by "vulture" investors.[88] This would have resulted in a lower return for the RTC and a greater loss for the taxpayers.[89] This situation was further exacerbated by the fact that insurance companies, traditionally large commercial real estate lenders, would not participate in RTC auctions.[90] Although an active secondary market for commercial real estate mortgages was previously non-existent, the RTC determined that securitization of its commercial real estate mortgages was the preferred way to dispose of its inventory.[91] The RTC securitized its inventory by pooling large numbers of commercial mortgages and selling these as securities to the public markets.[92] By July 1993, the RTC had securitized close to $14 billion of commercial mortgages.[93]

With the tightening lending environment, the RTC's large inventory, and the success of previous securitization efforts Wall Street found an unusual opportunity to become an alternative source of commercial real estate financing.[94] In the process, a viable secondary market for commercial real estate mortgage securities was created and CMBS became a reality.

IV. LOAN TRANSACTION

The structure of securitized commercial real estate loan transactions generally looks like other commercial real estate loan

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CENTER RES. 49, 65 (1996).

85. *See id.* A performing mortgage is one in which the borrower has, to date, fulfilled all of its obligations under the mortgage agreement. A non-performing mortgage is one in which the borrower has not fulfilled its obligations under the mortgage agreements.

86. *See id.*

87. *See id.*

88. *See id.*

89. *See id.*

90. *See id.*

91. *See id.*

92. *See id.*

93. *See* Jacob & Duncan, *supra* note 1, at 492.

94. *See* Ciochetti & Riddiough, *supra* note 84, at 67.

transactions.[95] However, when considering whether to borrow from a lender who will securitize the commercial real estate loan, the borrower must weigh the relative benefits of this type of borrowing against more traditional commercial real estate financing.

There are numerous benefits to borrowing from a CMBS lender as opposed to receiving financing from a traditional lender. The benefits include non-recourse loans,[96] lower transactional costs, availability of financing, and potentially lower interest rate financing.

However, the merging of securities and commercial real estate law can lead to difficulties. Since the commercial mortgages to be securitized will be pooled and eventually sold to investors, the borrower/lender relationship in this context is different than in traditional commercial real estate transactions. In the traditional commercial real estate financing situation, lenders review loan requests from the perspective of how the loan will perform in the lender's loan portfolio.[97] Since the individual commercial real estate loan is viewed as an individual transaction, the lender has greater flexibility in negotiating the terms of the loan. As a result of the this flexibility, borrowers expect to negotiate the terms of their commercial real estate loans. However, CMBS requires that the individual commercial real estate loan be viewed not as an individual transaction, but rather as part of an aggregated number of commercial real estate loans that will be joined with other commercial real estate loans to create a pool for securitization. This means that there is much less flexibility for the lender to negotiate specific terms of the loan. Thus, the borrower foregoes the ability to negotiate every term

95. Both transactions use mortgage documents, loan commitments, deeds of trust, loan agreements, promissory notes, assignments of leases and rents, subordination, non-disturbance and attornment agreements, as well as third party reports such as environmental reports and engineering and structural reports and appraisals.

96. Non-recourse loans are loans where the lender does not look to the borrower in case of default. Rather, the lender looks only to the collateral securing the loan for full satisfaction of the indebtedness. Although it is one of the most important advantages, if not the primary advantage, to borrowers, the non-recourse nature of the loan is not absolute. Generally, a lender maintains recourse against a borrower for environmental liabilities arising from the commercial real estate and for fraud, or any other type of misrepresentation on the part of the borrower. This is in contrast to a traditional commercial real estate loan where lenders maintain recourse against the borrower for any problems, especially default, that arise under the loan.

97. In the traditional setting, a commercial real estate lender (generally either a bank or a insurance company) held on to the loan as part of a portfolio of loans made by the lender. The lender used the loan as a revenue generating mechanism in the hopes of making a profit on each loan in its loan portfolio.

of the loan.

For instance, under the terms of the loan agreement, borrowers are prohibited from prepaying principal.[98] The prohibition or limitation on principal prepayment may exist even in the event of casualty or condemnation of the mortgaged property.[99] This is not normally the case in most traditional commercial real estate mortgages.[100] However, since CMBS investors expect a steady, predictable cash flow, prepayment of principal would disrupt that cash flow.[101] The prepayment of principal would also place the CMBS investor in the undesired position of accepting unwanted reinvestment risk.[102]

Another CMBS issue is the need to ensure that the potential bankruptcy of the borrower does not leave the commercial real estate securing the loan susceptible to the potential claims of the borrower's creditors.[103] The borrower must create a special purpose vehicle (SPV) that is a separate legal entity from the borrower.[104] The SPV's only role must be to borrow money from the lender.[105] The SPV can have no other creditor, unless otherwise permitted by the lender.[106] Without the use of the SPV, the potential liabilities of the borrower from other businesses or properties make the property securing the loan more susceptible to bankruptcy risk.[107] If an SPV is not used as the borrower, a bankruptcy filing by the borrower would, in the very least, entail an automatic stay and disrupt the cash flow from the property to the CMBS investor.[108]

Furthermore, since the interest rates for the commercial real estate loans are directly tied to Treasury obligations, the potential interest rate constantly fluctuates. Therefore, the interest rate for the

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98. *See* Joseph Philip Forte, *From Main Street to Wall Street: Commercial Mortgage-Backed Securities*, 10 PROB. & PROP. 8, 13 (1996). The borrower may be allowed to make principal prepayments, but severe principal prepayment penalties will likely be assessed. For all practical purposes, the penalties act as an effective curtailment on the prepayment of principal.

99. *See id.* at 13. Furthermore, in the event of casualty or condemnation, the borrower may be required to restore the property with insurance proceeds or a condemnation award. *See id.* at 13-14.

100. *See id.* at 14.

101. *See id.*

102. *See id.* at 14.

103. *See id.* at 13.

104. *See id.*

105. *See id.*

106. *See id.*

107. *See id.*

108. *See id.*; 11 U.S.C. § 362 (1994).

loan is not fixed until the last moment. Unfortunately, this means that borrowers will not know the exact interest rate until the end of the process. This is much later than with traditional commercial real estate financing.[109] However, this allows lenders to better manage their interest rate risk. The time between the point at which the loan interest rate is fixed and the point at which the loan is closed is very short. This ensures that the lender has minimal exposure to interest rate fluctuation risk, and allows the lender to hedge[110] its interest rate risk by trading the appropriate hedge investment instrument.

These issues, along with the need to keep each of the loans within the pool as similar as possible,[111] leave less room for the borrower to negotiate the loan documents than they would have with a traditional commercial real estate loan. Borrowers must recognize the trade-off before considering involvement in commercial real estate loans that will be securitized.

V. THE COMMERCIAL MORTGAGE BACKED SECURITY OFFERING

The mechanics of the security offering for commercial mortgage backed securities are straight-forward, although there may be unique issues that face CMBS offerings. Generally, all offers and sales of securities are subject to the registration requirements of section 5 of the Securities Act of 1933 (the 1933 Act),[112] subject to applicable exemptions provided in Section 3 and Section 4 of the 1933 Act.[113] The

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109. For example, if a borrower is using the loan transaction to refinance in order to raise capital to satisfy a balloon payment obligation on an existing mortgage, then the borrower needs a specific dollar amount to satisfy the payment due. If, due to fluctuating Treasury rates, the refinancing does not generate sufficient capital to satisfy the balloon payment, the borrower must find additional capital to satisfy the mortgage obligation. In the traditional commercial real estate loan transaction, the borrower's interest rates are more commonly tied to the prime rate. There is much less daily volatility in prime rate, but there is constant change in the Treasury rates due to the activity of the secondary market.

110. Hedging is a strategy that offsets investment risk by eliminating the possibility of future gain or loss. *See* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 237 (4th ed. 1995). Since lenders in CMBS transactions use the interest rates on Treasury obligations as the benchmark for the interest rates they quote to borrowers, the lenders must engage in a hedge transaction to eliminate the risk of future Treasury rate fluctuations.

111. The loans in the pool are kept similar to instill confidence in the rating agencies and the investors that the loans in the pool have the same obligations to perform and penalties for nonperformance.

112. 15 U.S.C. § 77e (1994).

113. 15 U.S.C. § 77c (1994); *see* Randal A. Nardone, *Commercial Mortgage Loan Securities*, *in* NEW DEVELOPMENTS IN SECURITIZATION 1993, at 61, 67 (PLI Real Est. L. &

goal of the federal securities laws is to ensure fair and full disclosure of information regarding the security and the issuer so that the reasonable investor can determine the relative merits of the security.[114]

Under the 1933 Act, there is a private placement exemption under Section 4(2).[115] This section exempts from the 1933 Act's registration requirements transactions that do not involve a public offering.[116] The private placement offering under Section 4(2) of the 1933 Act applies to offerings to qualified institutional investors[117] that are "sufficiently sophisticated and have sufficiently strong bargaining position that they do not need the protection of the federal registration requirement."[118] By allowing the institutional investors to purchase CMBS without prior registration, the efficiency and liquidity of the private market may increase, allowing more CMBS transactions to take place.[119] Regardless of the applicability of the Section 4(2) private placement exemption under the 1933 Act, Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act)[120]

Practice Course Handbook Series No. A4-4442 1993).

114. *See* Richard E. Mendales, *We Can Work It Out: The Interaction Of Bankruptcy And Securities Regulation In The Workout Context*, 46 RUTGERS L. REV. 1211, 1257-58 (1994).

115. 15 U.S.C. § 77d(2) (1994); *see also* Steven L. Schwarcz, *Structured Finance: The New Way To Securitize Assets*, 11 CARDOZO L. REV. 607, 632 (1990).

116. *See* Nardone, *supra* note 113, at 73.

117. Qualified institutional investors are entities "that in aggregate own[] and invest[] on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." 2 TAMAR FRANKEL, SECURITIZATION: STRUCTURE FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES § 12.16, at 26 (1st ed. 1991) (quoting Rule 144A, 17 C.F.R. § 230.144A(a)(1)(i) (1997)).

118. 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 251 (3d ed. 1995). For most CMBS private placement transactions, the investors are institutional investors. The private placement exemption also applies to qualified individual investors. *See id.* at 251. Rule 144A allows statutorily defined institutional investors to purchase securities under the private placement exemption without requiring them to comply with the two year holding period prior to resale of the security as long as resale is to statutorily qualified institutional investors. *See* 1 HAZEN, *supra*, at 302. The adoption of Rule 144A and the resulting ability of qualified institutional investors to resell commercial mortgage backed securities purchased in a private placement transaction increases the liquidity of the investment. *See* Shenke & Colletta, *supra* note 4, at 1408. While Rule 144A places no restrictions on the resale of the security, the investor reselling the security must take "reasonable steps to ensure that the purchaser is aware that the seller may rely on the exemption from the provisions of section 5 if the [1933] Act provided by this section." 2 FRANKEL, *supra* note 117, § 12.16, at 29 (quoting Rule 144A, 17 C.F.R. § 230.144A(d)(2) (1997)).

119. *See* 2 FRANKEL, *supra* note 117, § 12.16, at 25.

120. 15 U.S.C. § 77j(b) (1994).

and the corresponding Rule 10b-5[121] anti-fraud provisions apply.[122] Liability would exist for both exempt transactions and non-exempt offerings if the SPV used "any device, scheme, or artifice to defraud" or if it made "any untrue statement of a material fact or [omitted] to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading."[123]

If the CMBS transaction is a public offering, then the filing must comply with the requirements of the 1933 Act. Under the 1933 Act, the public offering of commercial mortgage backed securities are most commonly issued through shelf offerings, which require registration with the Securities and Exchange Commission (SEC).[124] Shelf registration is permitted under Rule 415 of the 1933 Act.[125] Shelf registration allows for the registration of securities that will be publicly offered on a delayed or continuing basis.[126] Shelf registrations allow for the filing of the registration statement without the offering or sale of all the securities registered.[127]

Offerings made with a shelf registration are used because of the interest rate risk associated with the length of time required to assemble a pool of commercial real estate mortgages.[128] The shelf registration process allows the issuer to satisfy the registration requirements of the 1933 Act at the same time as it acquires the commercial mortgages to be pooled.[129] When the commercial real estate mortgages are assembled and pooled, the registration requirements have already been met and the interest rate risk has been averted.[130]

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121. 17 C.F.R. § 240.10b-5 (1996).

122. *See* Schwarcz, *supra* note 115, at 634.

123. *Id.* at 634 (quoting SEC Rule 10b-5, 17 C.F.R. § 240.10b-5).

124. *See* Nardone, *supra* note 113, at 72-73.

125. *See id.* at 72; *see also* 17 C.F.R. § 230.415 (1996).

126. *See* Nardone, *supra* note 113, at 72.

127. *See* 1 HAZEN, *supra* note 118, at 176.

128. *See* 2 FRANKEL, *supra* note 117, § 12.18, at 38.

129. *See* 2 *id.*

130. *See* 2 *id.* at 38-39. The interest rate risk discussed here is the risk that without the use of shelf registration the registration process might take too long. *See* 2 *id.* at 38. This is problematic because commercial mortgage backed securities are very interest rate sensitive instruments. *See* 2 *id.* Because of the constant fluctuations in the Treasury market, the benchmark setting interest rates in CMBS transaction, a long registration period would require the issuer to assume greater interest rate risk. *See* 2 *id.*

However, the use of shelf registration requires the issuer to update the registration statement in order to reflect accurate and current information.[131] Any update is made by an amendment to the registration statement which is deemed to be a new registration statement for purposes of liability under the 1933 Act.[132]

The registration statement is basically a disclosure statement filed with the SEC.[133] Disclosure of the risks associated with the investment is at the heart of the registration process. Since most CMBS offerings are issued through the use of shelf registration, full disclosure in compliance with the 1933 Act in the Statutory Prospectus[134] and the Supplemental Prospectus[135] is essential. Liability can arise if the disclosures would have misled a reasonable investor about risks of the investment.[136]

The issuer must ensure that statements made in the prospectus and other registration statement filings "are not materially misleading in light of the total mix of information available to the investor."[137] The prospectus must accurately represent the investment strategy and provide sufficient explanation of the risks involved with the investment.[138] The prospectus must be read as a whole and the representations made in the prospectus, when taken together, must not mislead a reasonable investor about the investment risks.[139] If a prospectus "does not disclose material objective factual matters or buries those matter[s] beneath other information, or treats them cavalierly" then the prospectus violates the federal securities laws.[140]

Even if a prospectus identifies and includes cautionary language a court could disregard the warnings as boilerplate language insuffi-

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131. *See* 1 HAZEN, *supra* note 118, at 179-80.

132. *See* 1 *id.* at 180.

133. *See* 1 *id.* at 122.

134. *See* 15 U.S.C. §§ 77g, 77j (1996). The prospectus used at the time of the initial filing.

135. *See* 15 U.S.C. § 77j(a)(3) (1996). The amended prospectus that reflects all current and accurate information as of the time of the filing of the amendment.

136. *See* 1 HAZEN, *supra* note 118, at 173.

137. 1 *id.* at 174.

138. *See* Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 3 (2d Cir. 1996). In *Olkey*, Hyperion was offering a closed end mutual fund, whereas the typical CMBS transaction is structured as a pass-through certificate. *See id.* Hyperion was investing in mortgage backed securities. *See id.* Although, the investment instrument used by Hyperion differed from the typical CMBS transaction, the disclosure requirements are the same.

139. *See id.* at 5.

140. *Id.*

cient to satisfy the disclosure requirements of the 1933 Act.[141] Boilerplate language can best be described as language that is "too generic to take seriously."[142] While courts have found general language of risk sufficient to ensure that the cautionary language of the prospectus is not deemed boilerplate, the prospectus' warnings of the investment's risk should be extensive and detailed.[143]

As additional protection, courts have adopted the "bespeaks caution doctrine," which holds that cautionary language about the investment risk may be sufficient to preclude liability arising from individual misstatements or omissions in connection with projections and estimates made by the issuer.[144] The "bespeaks caution doctrine" focuses on the total mix of information available to the investor when determining if misstatements or omissions are material.[145] Ultimately, "[i]n order for the bespeaks caution doctrine to justify the dismissal of fraud claims, the cautionary language must be sufficient to negate any reasonable reliance on predictions that may appear optimistic."[146]

The goal of the disclosure requirement of the 1933 Act is to protect reasonable investors from being misled about the risks associated with the investment. As long as the prospectus contains no material misstatements or omissions of facts and the cautionary language is not so generic as to be deemed boilerplate, then the prospectus will accurately represent the investment strategy and provide sufficient explanation of the risks involved with the investment. As such, a prospectus of this sort should not create liability for the issuer.

VI. CHALLENGES FACED BY THE CMBS MARKET

In order to create a viable CMBS market, a number of challenges need to be confronted. The challenges are as follows: (1) dealing with the non-fungibility of commercial real estate and the homogenization of commercial real estate financial structures;[147]

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141. *See id.*

142. *Id.* at 8.

143. *See id.*

144. *See* 1 HAZEN, *supra* note 118, at 173-74.

145. *See* 1 *id.* at 174.

146. 1 *id.* at 174-75.

147. *See* Sally Gordon, *A Compelling Case for Commercial Real Estate Securitization*, Mortgage-Backed Securities Letter No. 39, Sept. 26, 1994, *available in* 1994 WL 2546170 (IAC Newsletter Database). For further discussion, see *infra* notes 151-86 and accompanying text.

(2) defining the role of the rating agencies and the loan servicer;[148] and (3) creating structures that were isolated and independent. The structures were needed to protect the underlying assets from the potential bankruptcy risk of the former asset owners.[149] This section explores in broad terms the CMBS market's response to these challenges.

A. *Non-Fungibilty*[150]

Investors' concerns about the non-fungibility of commercial real estate were diminished with the realization that it was the cash flows of the commercial property that were being securitized.[151] For CMBS investors, the consistency and predictability of the income stream created by the mortgage payments mattered most, and the differences in the real estate assets securing the mortgages became less important.[152] Since it was not the underlying real estate that was being securitized, but rather the cash flow produced by that real estate, the real estate securitized became fungible.[153] This allowed investors to cast off traditional notions of commercial real estate investing and find the value of the commercial real estate security in the cash flow generated by the property.[154] The investment analysis focused on the cash flow generating a reasonable return on the investment instead of focusing on the potential sale of the property as the vehicle generating the return on investment.[155]

B. *Homogenization of Commercial Real Estate Finance Structures*

Generally, the financing structure and terms of individual commercial real estate mortgages varied widely, as did the criteria used

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148. *See Commercial MBS: Service On The Mind,* Mortgage-Backed Securities Letter No. 9, Nov. 20, 1995, *available in* 1995 WL 9893496 (IAC Newsletter Database); *see also* Howard A. Zuckerman, *Stacey Berger Discusses the Expanding Role of Servicer and CMBS Transactions,* CAPITAL SOURCES FOR REAL ESTATE, Sept. 1995, at 10. For further discussion, see *infra* notes 187-215 and accompanying text.

149. *See Structured Financing Techniques, supra* note 15, at 529; *see infra* notes 216-44 and accompanying text.

150. Non-fungibility of commercial real estate simply means that one commercial real estate project cannot be replaced by another commercial real estate project. *See* Gordon, *supra* note 148.

151. *See id.*

152. *See id.*

153. *See id.*

154. *See id.*

155. *See id.*

by lenders to qualify commercial real estate borrowers.[156] This raised concerns that each commercial real estate loan transaction differed so greatly that these loans may not have been amenable to pooling.[157]

The need to make these loans more amenable to pooling by creating more uniformity in the loan origination function was driven by the growing CMBS market for predictability and consistency.[158] In 1994, approximately $20 billion in CMBSs were issued.[159] In 1995, over $18 billion in CMBSs were issued with $8 billion coming in the final quarter.[160] Due to the increasing volume of CMBS and the maturing nature of the CMBS market, the lending interest rate spreads over the Treasury rate narrowed and provided lower interest cost to borrowers.[161] However, this also meant that the potential return for CMBS investors was also narrowing. Thus, uniformity in the origination documentation became important because CMBS investors need to be able to analyze the risks of each loan in the securitization pool as well as the risks of each CMBS transaction as an investment instrument. Currently, no standardized documentation to securitize commercial real estate loans exists.

In 1996, representatives of the Mortgage Bankers Association of America, National Association of Realtors, the National Realty Committee, and members of the legal, financial, and investment community, created the Capital Consortium to begin establishing "common parameters and documentation" for CMBS.[162] The consortium's goal was to create a standard for the marketplace by 1999.[163] The consortium focused on four areas of CMBS: first, the development of template documentation for the loan transaction in CMBS;[164] second, the creation of a due diligence checklist to be used to identify specific information that will assist in expediting the loan transac-

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156. *See id.*

157. *See id.*

158. *See id.*

159. *See* Alvin L. Arnold, *Mortgage Securities: CMBS Market Review*, Mortgage & Real Est. Executives Rep. No. 3, Apr. 1, 1996.

160. *See id.*

161. *See id.* Generally, loan originators for CMBS use the interest rate of Treasury obligations as the benchmark by which they set their lending interest rates.

162. *Consortium Set Guidelines for CMBS*, Mortgage-Back Securities Letter No. 27, July 1, 1996, *available in* 1996 WL 8090821 (IAC Newsletter Database) [hereinafter *Consortium Sets*].

163. *See id.*

164. *See id.* For further discussion, see *infra* notes 170-81 and accompanying text.

tion;[165] third, the creation of data collections and information guidelines;[166] and fourth, the establishment of a public policy initiative to facilitate regulatory and legislative change in order to facilitate CMBS.[167]

The mortgage template developed by the Capital Consortium is a generic form to be used as a guide for securitizing commercial real estate transactions.[168] The template was not developed to create a standard mortgage document.[169] The template was created to facilitate securitization of commercial real estate debt, thereby creating greater liquidity and efficiency in the secondary market.[170] In addition, the mortgage template should also facilitate the underwriting, the origination, and the pooling of loans intended to be securitized.[171]

The Capital Consortium's mortgage template hopes to promote uniformity and structural consistency in capital market commercial real estate transactions by organizing the documents in a more standardized way.[172] This standard approach offers key information for credit rating analysis purposes and for investment decisionmaking by interested third parties who are trying to compare transactions.[173] The template is designed to achieve five purposes.[174] First, the template attempts to standardize the location of provisions so that relevant sections of the document can be readily located and reviewed by interested parties.[175] Second, the template attempts to identify certain standard clauses that can be deleted by the parties if

165. *See Consortium Sets*, *supra* note 162. For further discussion, see *infra* notes 182-84 and accompanying text.

166. *See infra* note 185 and accompanying text. The data and information guidelines will assist in standardizing like information by data fields. Further, it will require updating procedures so that the investing community has sufficient information. This will create a more efficient market. *See Consortium Sets*, *supra* note 162.

167. *See infra* note 186 and accompanying text; *see also Consortium Sets*, *supra* note 162.

168. *See* THE CAPITAL CONSORTIUM, CAPITAL MARKETS INITIATIVES, at Caveat (June 1996).

169. *See id.* at 7.

170. *See id.*

171. *See id.* at ii (referring to a letter from the Capital Consortium Steering Committee).

172. *See id.* at 2.

173. *See id.*

174. *See id.*

175. *See id.* Generally, the interested parties are rating agencies and potential investors.

they are inappropriate for specific real estate transactions.[176] Third, the template provides space for inserting appropriate and necessary state-specific clauses relating to real property legal issues.[177] Fourth, the template attempts to establish certain basic, universal concepts that are utilized in CMBS loan transactions.[178] Finally, the template attempts to "outline material aspects of mortgage loans for users when they initially prepare the documents."[179] However, the mortgage template is not geared toward overly complicated and complex commercial real estate transactions that may require traditionally negotiated documents due to the nature of the specific commercial real estate transaction.[180]

In addition, the Capital Consortium created a Due Diligence Checklist to insure that all information required for the loan transaction is located within the loan document file.[181] The goal of the Due Diligence Checklist is to provide a simple recording method that insures all the required information is included in the loan document file.[182] The Due Diligence Checklist is expected to "ease review of loan document files, thereby expediting transaction execution."[183]

The Capital Consortium created Data Elements Guidelines "aim[ed] at providing a comprehensive, uniform data framework for issuers, investment bankers, loan servicers and investors to better manage information at the security, class, pool, loan, property and tenant levels."[184] Finally, the National Public Policy and Initiatives Update "focus[es] on identifying and monitoring public policy issues affecting the short and long term flow of both debt and equity capital into the commercial real estate sector."[185]

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176. *See id.*

177. *See id.*

178. *See id.* These universal concepts include a covenant to pay debt, a grant of security interest in the collateral, certain representations and warranties, and other standard legal issues, in addition to mechanical aspects of the loan transaction such as method of payment. *See id.*

179. *Id.*

180. *See id.* at 7.

181. *See id.* at 2.

182. *See id.*

183. *Id.*

184. *Id.* at 3.

185. *Id.* at 85.

C. *Role of Rating Agencies*

In 1985, the development of the CMBS market was greatly assisted by the national credit rating agencies'[186] implementation of a credit rating system for commercial mortgages.[187] By extending credit ratings to commercial real estate transactions, the rating agencies made the existence of a secondary market more feasible. Credit ratings for CMBS allowed investors to compare commercial mortgage backed securities to corporate debt securities based on the ratings awarded to each.[188] The rating agencies rated the creditworthiness of the issuer and the likelihood of repayment of the debt in much the same manner as they rated corporate debt securities.[189] Thus, the highest rated commercial mortgage backed security could be compared to the highest rated corporate bond or other similarly rated instrument.[190] Furthermore, credit ratings allowed lending by nontraditional investors who either lacked real estate expertise or whose investment strategy limited their investing to only rated debt obligations.[191]

D. *Role of the Loan Servicer*

Securitization requires that the commercial real estate loans in the pool be monitored to ensure that each borrower is in compliance

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186. Standard & Poor's, Moody's Investors Services, Duff & Phelps, and Fitch Investors Services are national credit rating agencies that rate commercial mortgage backed securities.

187. *See* Shenke & Colletta, *supra* note 4, at 1401. The first rating, done in 1985, was for a single property commercial financing; thereafter, in 1987, the first pool of commercial real estate loans was rated. *See id.* These credit rating agencies had been assigning credit ratings to residential mortgages since 1975. *See id.* For rating residential mortgage pools, the agencies developed a statistical analytic method that allowed them to evaluate the cash flow generated by the pool of residential mortgages, rather than basing their credit rating on the collateral value of the underlying residential property in the pool or evaluating the credit rating of the issuer. *See id.* The development of the credit rating criteria for commercial real estate financing was based upon the same credit rating methodology developed for residential mortgages. *See id.* at 1401-02. This is more the case when the rating agencies were evaluating a pool of commercial real estate transactions. In the case of single property specific transactions the rating agencies evaluate the property on the individual aspects of the specific property: the property's rent roll, appraisal value, and other real estate underwriting criteria more common to traditional commercial real estate lenders. *See id.* In addition, as part of their analysis, the rating agencies look at the bankruptcy remoteness of the issuer as well as other real estate issues relating to title and property of the mortgage securing the property. *See id.*

188. *See id.* at 1401.

189. *See* Richards, *supra* note 4, at 114.

190. *See id.*

191. *See* Shenke & Colletta, *supra* note 4, at 1401-02.

with the loan terms. The duty to monitor compliance with the terms of each commercial real estate loan in the pool falls upon the loan servicer.[192] The loan servicer may be either a third party or the transferor (sometimes called the seller-servicer).[193] There are two types of loan servicers: master servicers and special servicers.[194]

The master servicer is responsible for the commercial real estate loans that substantially comply with the terms of the loan agreements. The master servicer collects payments in satisfaction of the installment payment obligation of the borrower and remits those funds to the SPV for the benefit of the CMBS investors.[195] The master servicer also advances capital to cover any shortfall that arises from borrower delinquencies.[196] If there are payment shortfalls from any of the commercial real estate loans, either due to delinquencies or loan defaults, the master servicer provides sufficient capital to ensure that the investors are paid.[197] Furthermore, the master servicer advances capital to pay for items such as property taxes and assessments and insurance premiums.[198]

In addition, the master servicer monitors the changes in both the cash flow of the commercial real estate and the market value of the commercial real estate acting as collateral.[199] The master servicer regularly reports to the investors, the underwriters and the rating agencies the status of the loans, the cash flow of the properties, and the market value of the property.[200] The reports also include information such as site inspections, property operating statements, rent rolls, and financial and market information.[201]

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192. *See* Zuckerman, *supra* note 148, at 10.

193. *See Structured Financing Techniques*, *supra* note 15, at 548. However, if the originator/transferor is the servicer, then concerns regarding the absolute transfer through a true sale may arise. *See infra* note 227 and accompanying text.

194. *See* Zuckerman, *supra* note 148, at 10.

195. *See id.*

196. *See id.*

197. *See id.*

198. *See id.*

199. *See* Zuckerman, *supra* note 148, at 10. Monitoring the changes is important for two reasons. First, declines in the cash flows of the commercial real estate could affect the ability of the borrower to satisfy the monthly installment payment obligations. Second, reductions in the value of the commercial real estate acting as collateral would leave less value supporting the indebtedness in case of default.

200. *See id.*

201. *See id.*

The special servicer deals exclusively with non-performing loans.[202] The special servicer is responsible for working out the non-performing loan, and for managing and liquidating any properties that have been foreclosed upon.[203]

No standard, industry-wide formula for determining when a loan moves from a delinquent loan status to a defaulting loan status exists.[204] The master servicers make this determination.[205] The determination that a loan is no longer viable and that the advances made by the master servicer on behalf of the delinquent loan are no longer recoverable has great impact on the CMBS investor. When such a determination is made, the loan is transferred to a special servicer and the master servicer is no longer required to make capital advances to cover shortfalls.[206] Therefore, for investors to receive any return from the loan, they must wait for the special servicer to either work-out or liquidate the non-performing loan.

In addition, both master and special servicers must be aware of their fiduciary responsibilities. The loan services owe fiduciary duties to the SPV and CMBS investors.[207] The loan servicers should be aware that conflicts may arise between classes of CMBS investors that may make it hard to maintain their fiduciary responsibilities to the different classes.[208] Although not in a fiduciary relationship with the loan servicers, the underwriters and the ratings agencies also rely on the servicers for prompt and accurate information about the CMBS transaction.[209] Furthermore, because other parties also rely on the loan servicer, the loan servicer may have greater difficulty maintaining its fiduciary responsibility to the different classes of CMBS investor.[210] Loan servicers play an important role in the success of

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202. *See id.* Non-performing loans are loans in which the borrowers are delinquent and need assistance to comply with the terms of the loan agreement or the borrowers are considered to be in default.

203. *See id.*

204. *See id.*

205. *See id.*

206. *See id.*

207. *See id.*

208. *See id.* If different tranches receive different yields on their bonds, then the decisions made by the master servicer may effect the sought after yields the investor expected to receive. *See id.* For example, the investors in each individual tranche may have conflicting interests when a delinquent loan is determined to be a defaulting loan and transferred to the special servicer. *See id.*

209. *See id.*

210. *See id.*

each CMBS transaction and an important role in the ongoing success of CMBS in general.

E. *Bankruptcy Remoteness*

Securitization serves many important functions, including the protection of assets from the potential bankruptcy of the asset originator/transferor.[211] The structure of a commercial real estate securitization requires that the loan pool be transferred on an absolute basis to a legally separate entity, the SPV.[212] The SPV's activities are limited to acquiring the assets to be securitized and selling interests in the assets.[213] In its most basic and straightforward design, the SPV receives (through a "true sale"[214]) the assets to be securitized from the originator/transferor.[215] Once the SPV receives the assets, the SPV raises funds from third party investors either through debt financing or through a sale of interests in the SPV itself.[216] The capital contributions made by the third party investors are then delivered to the originator/transferor as payment of the purchase price of the assets transferred to the SPV.[217]

The sale of the assets from the originator/transferor to the SPV must be structured to create a "true sale" of the assets.[218] To insure that the transfer constitutes a "true sale" the originator/transferor can have neither legal nor equitable interests in the assets to be securitized.[219] In determining whether the transaction qualifies as a true sale, courts generally consider whether five elements are satisfied. First, and perhaps most important, the risk of loss arising from the transferred assets must be sufficient to place the risk with the SPV,[220]

211. *See Structured Financing Techniques*, *supra* note 15, at 553.

212. *See id.* at 541. The SPV is the entity through which the securitization activities take place. *See id.* at 533. The activities of the SPV are limited to financing matters. *See id.*

213. *See id.* at 568.

214. *See infra* notes 225-34 and accompanying text.

215. *See Structured Financing Techniques*, *supra* note 15, at 567-68. The true sale requirement is a matter of substance over form. *See id.* at 542.

216. *See id.* at 568.

217. *See id.*

218. *See id.* at 568.

219. *See id.* at 533.

220. *See id.* at 543. The transfer of the risk of loss is measured by the amount of recourse against the originator/transferor for losses suffered by the SPV. If there is excessive recourse left with the originator/transferor, then the court may view the transfer as a loan, not a sale. However, credit enhancement devices, such as letters of credit, surety bonds, and subordinated interests, do not constitute excessive recourse sufficient to

and there must be a fairly valued purchase paid for the transferred assets.[221] Second, the originator/transferor cannot retain any benefits of ownership of the transferred assets.[222] Any ability of the originator/transferor to capture an increase in the value of the transferred assets would constitute a benefit of ownership.[223] Third, the originator/transferor cannot maintain any control over the transferred assets.[224] Fourth, the originator/transferor cannot continue to show the transferred property on its own books.[225] Finally, the parties must intend that the transfer be absolute.[226]

In addition, the transaction must be structured to minimize the likelihood that the transferred assets will be consolidated[227] with the originator/transferor's assets if the originator/transferor files for bankruptcy.[228] Individual creditors of the separate entities existing before consolidation can become joint creditors of the post-consolidation debtor.[229] Creditors seek to use consolidation to join the unencumbered assets of an interrelated entity in order to increase

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nullify the transfer. *See id.* at 543-46, 549-50.

221. *See Structured Financing Techniques*, *supra* note 15, at 546. If the consideration paid for the transferred assets is overly discounted when compared to the market value of the asset, a court may consider the transfer a fraudulent conveyance. *See id.* at 548.

222. *See id.* at 546.

223. *See id.*

224. *See id.* If the originator/transferor is acting as the loan servicer (sometimes called a seller-servicer), it is important that its actions as servicer are consistent with an arms length transaction. Otherwise, a court may determine that a true sale of the assets did not exist, which would leave the SPV open to potential bankruptcy liability of the originator/transferor. *See id.* at 548. To ensure that the transaction is deemed an arms length transaction: (1) the seller-servicer must receive a servicing fee from the SPV comparable to a fee that a third party servicer would receive; (2) the SPV should have the ability to revoke the servicing agreement with the seller-servicer as it would under the terms of an agreement with a third party servicer; (3) all of the records of the seller-servicer should identify the assets securitized as property of the SPV. *See id.* at 548-49. In addition, if a seller-servicer must provide capital to cover any shortfall in income from the asset pool or advance capital for the payment of expenses, then the seller-servicer must do so in a manner consistent with the originator/transferor as seller-servicer, and not by accepting any further credit risk for the assets in the pool. This is necessary so that the true sale nature of the transfer is not lost, which would thereby leave the SPV open to potential bankruptcy liability of the originator/transferor seller-servicer. *See id.* at 551.

225. *See id.* at 546-47.

226. *See id.* at 547.

227. Consolidation takes the assets and liabilities of separate entities (in this case the originator/transferor and the SPV) and treats them as a single entity. *See* 4 J. STEPHEN GILBERT & PHILIP J. HENDEL, CHAPTER 11 THEORY AND PRACTICE: A GUIDE TO REORGANIZATION § 24.01 (James F. Queenan et al. eds., 1994).

228. *See Structured Financing Techniques*, *supra* note 15, at 533.

229. *See* 4 GILBERT & HENDEL, *supra* note 230, § 24.02.

the assets from which the debtor can satisfy debt owed to its creditors.[230] Consolidation would increase the asset pool from which the debtor could repay the outstanding indebtedness to its creditors.

While there is no statutory authority for consolidation, bankruptcy courts use their equitable power to consolidate the assets of separate entities.[231] The corporate veil may be pierced if the courts, in their discretion, determine that the entities do not have distinct independent existences.[232]

Finally, if a bank acts as an originator/transferor of the assets to be securitized, there may be special issues to consider.[233] Since banks fall outside normal bankruptcy proceedings,[234] the structure of the transfer must insure that the assets will not be available to satisfy an insolvent bank's creditors. In bank insolvency, "no special power exist[s] for creditors to reach the assets of [the] affiliates."[235] If the transfer is structured properly, an SPV, as a subsidiary,[236] should satisfy the affiliate requirement and avoid the claims of the insolvent bank's creditors.

VII. THE ROLE OF CMBS IN NORTH CAROLINA

The impact of CMBS in the North Carolina banking community has been mixed. For First Union and NationsBank, CMBS has become important to their overall commercial real estate lending strategies.[237] By contrast, the impact of CMBS on BB&T, CCB, Cen-

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230. *See* 4 *id.* § 24.02.

231. *See* 4 *id.* § 24.03-.04.

232. *See* 4 *id.* § 24.03.

233. *See generally* Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469 (1992) (noting that the increase of bank insolvencies during the 1980s gave rise to greater power for regulatory agencies in dealing with insolvent banks).

234. *See* 11 U.S.C. § 109(b)(2) (1994) (stating that banks are not debtors for the purpose of the applicability of the Bankruptcy code).

235. Swire, *supra* note 233, at 482.

236. *See* 1 FRANKEL, *supra* note 117, § 10.9, at 429-39.

237. The power of banks to securitize loans, such as commercial real estate loans, appears to conflict with certain prohibitions set forth in the Glass-Steagall Act. The Glass-Steagall Act prohibits banks that are members of the Federal Reserve System from "investing in, issuing, distributing, selling, trading in and underwriting securities, and from being affiliated with an entity that engages in these activities." 2 FRANKEL, *supra* note 117, at § 16.4, at 139-40 & nn.1-4 (discussing the prohibitions set forth in the Glass-Steagall Act and, in that respect, identifying the terms "member bank," "underwriting securities," and "affiliated" (citing 12 U.S.C. §§ 24(seventh), 221, 221a(b) (1994))). However, in 1989, the Second Circuit overturned a federal district court and held that the determination of the Comptroller of the Currency to allow banks to use mortgage pass-

tura, and Wachovia has been nonexistent. First, this section explores the strategies that First Union and NationsBank have adopted to integrate CMBS into their commercial real estate lending. Then, this section analyzes why BB&T, CCB, Centura, and Wachovia have not utilized CMBS for their investment portfolios.

A. *First Union National Bank: First Union Capital Markets*[238]

In June 1994, First Union decided to augment its traditional commercial real estate lending by creating First Union Capital Markets Commercial Real Estate Finance group (CREF). CREF was created to implement First Union's CMBS strategy. Initially, First Union's strategy was to use CMBS to increase service to its existing borrowers.[239]

First Union believed that it might be placed at a competitive disadvantage if it did not provide CMBS services to its existing customers. First Union was concerned that other financial institutions might make commercial real estate loans secured by those "B" and "C" properties that First Union, using its traditional credit risk analysis, would not make.[240] Although first viewed as an attempt to service its existing commercial real estate customers, First Union's entrance into CMBS quickly expanded beyond this initial strategy. CREF now acts as a profit center for First Union in two ways: by earning fees for originating the loans[241] and by earning money from CMBS sales.[242]

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through certificates did not violate the Glass-Steagall Act. *See* Securities Indus. Ass'n v. Security Pac. Nat'l Bank, 885 F.2d 1034 (2d Cir. 1989). *See generally* 2 FRANKEL, *supra* note 117, at §§ 16.4 to 16.5, at 139-48 (discussing the interplay between CMBS and the Glass-Steagall Act). A more complete discussion of the Glass-Steagall Act is outside the scope of this Comment.

238. Interview with Lawrence A. Brown, Senior Vice President and Managing Director of First Union Capital Markets Commercial Real Estate Finance, in Charlotte, N.C. (Jan. 3, 1997).

239. First Union believed that many of its "A" quality real estate borrowers had "B" and "C" type commercial real estate that needed financing. First Union also believed that with CMBS they could make loans secured by "B" and "C" commercial real estate without assuming the risk of placing "B" and "C" commercial real estate property into the bank's real estate loan portfolio. Loans secured with "B" and "C" commercial real estate posed a greater default risk than was acceptable.

240. This might have put First Union at risk of losing their customers to other institutions that were willing to assist borrowers on higher risk assets. Those customers, who received financing elsewhere, might reward the lender who was willing to accept the credit risk for loans secured by "B" and "C" property by moving the rest of their business.

241. It is less likely that CREF would earn origination fees on loans originated by third party correspondents.

242. When CREF makes loans to borrowers, depending on the length of the loan,

In 1996, CREF closed approximately $1.5 billion worth of commercial real estate loans for securitization. Approximately one third of the loans were generated by CREF itself, approximately one third were generated by third party correspondents for CREF, and approximately one third were generated by intrabank correspondents responsible for origination of loans within specified territories of the First Union banking system.[243] In addition, CREF was involved with two CMBS offerings with Merrill Lynch. First Union and Merrill Lynch pooled their commercial real estate loans and their distribution network in the combined offerings.

CREF has concentrated its efforts in conduit CMBS transactions[244] closing loans that are pooled and then securitized. In addition to the geographic diversification created by its origination strategy, CREF makes loans on diverse types of property. CREF's commercial real estate loans include, but are not limited to, multi-family residential property, retail commercial property, industrial real estate, office real estate, health care related property, hotels, and mobile home parks.

CREF has also begun to make loans in the specialized area of Credit Tenant Leases (CTL). The CTL program makes loans on in-

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CREF uses Treasury obligations of corresponding length plus a negotiated spread on basis points above the Treasury obligations to determine the appropriate interest rate on the loan. Once the loan interest rates are locked in, CREF must hedge against interest rate fluctuation by trading Treasury obligations. Once the loans are pooled, CREF creates investment tranches with the goal of dividing the pool into as large a percentage of AAA pieces as possible and as small a percentage of unrated pieces as possible. The larger the percentage of higher rate tranches that can be carved out of the loan pool, the lower aggregate interest rate the CMBS conduit will have to pay to investors. CREF makes money by reducing the aggregate interest paid to investors while attempting to achieve the highest possible aggregate interest paid by borrowers. Treasury obligations are used as a baseline, and the measure of interest rates is the basis points over the Treasury obligations at the time the loans were made and the basis points over the Treasury obligations at the time the CMBS bonds were sold. By using Treasury obligations as a baseline, the hedging activity of CREF becomes essential for CREF to maintain its desired basis point spread over Treasury obligations.

243. Currently, First Union has six intrabank correspondents covering Tennessee, North Carolina, Georgia, Florida, Virginia, Maryland, the District of Columbia, and the Northeast United States.

244. *See supra* notes 10-14 and accompanying text. Conduit transactions offer the greatest possible diversity of loans to potential CMBS investors, thereby lessening investment risk. The pool is diversified by the geographic location of the commercial real estate property and by the type of commercial property included in the pool. The CREF loan origination mechanism allows it the opportunity to close loans from all geographic regions within the United States. The intrabank correspondents focus on the creation of loans within their specific geographic region, while CREF and third party correspondents attempt to originate loans from all geographic regions of the United States.

dividual real estate parcels where the lease obligations are guaranteed by corporations with investment grade credit ratings. The focus of CTL is not only on the cash flow generated by the property itself but also on the creditworthiness of the lease guarantor. Because this is such a unique type of commercial real estate loan, CREF plans to pool its CTL loans separately from other commercial loans and offer a CMBS transaction containing only CTL loans.

Finally, CREF concentrates its lending activity on loans between $1 million and $25 million. This loan size minimizes the potential impact of a small number of loan defaults. The impact of a default is reduced because no one loan represents a disproportionate percentage of a $500 million to $1 billion pool.

First Union's entry into the CMBS market created another profit center for the bank while allowing it to satisfy its overall commercial real estate strategy. This success should guarantee First Union's continued participation in the CMBS market.

B. NationsBank: NationsBanc Capital Markets[245]

NationsBank and its predecessors experienced large commercial real estate loan losses due in part to acquisitions of failing institutions that faced large commercial real estate write-offs. Securitization of commercial real estate loans allows NationsBank to remain active in commercial real estate lending while, in large part, eliminating commercial real estate risk. Furthermore, CMBS enables NationsBank to capitalize on its relationships with borrowers.

NationsBank is one of the largest commercial real estate lenders in the country, originating between $7.5 billion and $10 billion worth of loans each year. In 1996, NationsBank securitized approximately $1.4 billion of commercial real estate and securitized an additional $800 million from its credit-backed mortgage program.[246] NationsBank has adopted a broad approach toward participation in the CMBS market and has focused on differing types of commercial real estate. NationsBank has securitized loans on multifamily residential

245. Interview with Kenneth A. Rivkin, Managing Director, Commercial Mortgage Trading, NationsBanc Capital Market Real Estate Finance, in Charlotte, N.C. (Jan. 20, 1997).

246. The credit-backed mortgage program makes loans on individual real estate parcels where the lease obligations are guaranteed by corporations with investment grade credit ratings. The credit-backed mortgage program is not only on the cash flow generated by the property itself, but also on the creditworthiness of the lease guarantor.

and commercial real estate,[247] Section 42 property,[248] credit-backed mortgages, distressed real estate[249] through conduit transactions, and single asset transactions.[250]

NationsBank has divided the responsibilities for its CMBS program into two distinct functions: the distribution function and the origination function. The distribution function handles the sale of the CMBS product and the hedging activity of the real estate finance group.[251] The distribution function allows NationsBank discretion to determine whether their CMBS offering should be sold through their distribution system or in partnership with another distribution system. The development of this independent distribution function permits NationsBank to retain more of the sales fees generated by their CMBS offerings.

Another important component of the distribution function is the dissemination of NationsBank's investment analysis and reports to its clients. The research generated by NationsBank assists clients in evaluating investment opportunities available to them.

The origination function is responsible for the creation and structuring of the commercial real estate loans for securitization. The bank will originate loans between $1 million and $50 million per transaction. NationsBank uses internal and external origination sources for its CMBS product. Internally, the bank takes advantage of its commercial banking network to refer potential commercial real estate borrowers to the capital markets real estate finance origination group. The real estate finance group of NationsBanc Capital Mar-

247. NationsBank classifies its commercial real estate programs into shopping centers (strip centers and enclosed malls), industrial real estate, office real estate, and health care related real estate, such as nursing homes.

248. The goal of Section 42 of the 1986 Budget Reform Act is to use tax credits rather than direct government funding to encourage the construction, acquisition or rehabilitation, and increased development of affordable housing for low income citizens. *See* NATIONSBANK, N.A., COMMERCIAL MORTGAGE RESEARCH SECTION 42 LOANS 2 (1995); *see also* 26 U.S.C. § 42 (1994).

249. Distressed real estate is best described as non-performing real estate. The Resolution Trust Corporation, which was established by Congress in response to the savings and loan crisis, took the lead in the securitizing of distressed real estate. *See* NATIONSBANK, *supra* note 248, at 2.

250. Single asset transactions is either the securitization of a single property or the securitization of all the property of a single borrower. As an example of a single asset securitization, in 1996 NationsBank securitized the 55 story class "A" office building in Atlanta, Georgia, known as the NationsBank Plaza. *See* CSC ASSOCIATES, L.P., OFFERING CIRCULAR 5 (1996).

251. NationsBank believes that its distribution function area is equivalent to any sales network established on Wall Street.

kets also originates loans. These two sources serve as the internal origination mechanism of the bank. In addition, the bank uses external loan originators,[252] attempting to originate loans from all geographic regions of the United States. These third party originators loan origination outside of NationsBank's commercial bank network.

Participation in the CMBS market has been an extremely successful strategy for NationsBank. CMBS allows NationsBank to remain one of the largest loan originators in the United States without assuming the credit risk associated with commercial real estate loans, thus satisfying its strategic goal.

C. *BB&T,*[253] *CCB,*[254] *Centura,*[255] *Wachovia*[256]

Although CMBS has become a viable alternative to traditional commercial real estate lending for First Union and NationsBank, other North Carolina banks have used CMBS neither as a lending strategy[257] nor as an investment alternative for their investment portfolios.[258] Not only have BB&T, CCB, Centura, and Wachovia chosen not to originate CMBS, they have also opted not to invest in CMBS.

Currently, BB&T has approximately $5.5 billion in its investment portfolio.[259] CCB has $1 billion in the bank's investment portfolio, Centura has $1.4 billion in its investment portfolio, and Wachovia has $8 billion in its investment portfolio.

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252. According to Mr. Rivkin, the relationships between NationsBank and the third party originators are either exclusive relationships or "semi-exclusive" relationships.

253. Telephone Interview with Gypsy McKenzie, Senior Vice President and Portfolio Manager, Branch Banking & Trust Co. (Jan. 3, 1997).

254. Telephone Interview with Leo Pylypec, First Vice-President and Asset Liability Manager, Central Carolina Bank & Trust Co. (Jan. 9, 1997).

255. Telephone Interview with Nat Siewers, Senior Investment Officer, Centura Bank Co. (Jan. 10, 1997).

256. Telephone Interview with Michael G. Sebesta, Vice President and Portfolio Manager, Wachovia National Bank & Trust Co. (Jan. 10, 1997).

257. These banks have not turned to CMBS because they do not generate sufficient volume and diversification of commercial real estate loans to warrant a securitization effort.

258. Outside of their investment portfolio, however, Mutual Funds or certain trust investments managed by North Carolina banks may invest in CMBS. First Union and NationsBank also may trade CMBS for customers as part of their investment bank activities. However, these inquiries are outside the scope of this Comment.

259. When the acquisition of United Carolina Bank is complete, BB&T will have over $6.5 billion in its investment portfolio.

The investment philosophy of these banks has been extremely conservative. These banks are concerned about the preservation and protection of capital, liquidity management, and interest rate risk management when making investments for their respective investment portfolios. Two specific reasons explain why these banks do not invest in CMBS for their investment portfolios. First, they are concerned by the perceived lack of liquidity of the CMBS market. These banks do not believe that commercial mortgage backed securities offer sufficient liquidity to satisfy the investment portfolio's investment criteria.[260]

Second, these banks do not invest in CMBS because these banks assign the responsibility of making determinations on real estate credit risk to their respective loan portfolios and not to their investment portfolios. The banks view CMBS as commercial real estate loans and they believe that the underlying credit risk for each individual loan in the CMBS pool does not warrant the associated risk of the investment. Furthermore, these banks have active commercial loan operations that enjoy the expertise necessary to fully evaluate commercial real estate loans that satisfy these institutions' credit criteria. Instead of allowing the CMBS loan originator to determine the potential for non-performance of the individual loans within the CMBS pool, these banks would rather manage their own commercial real estate lending. These banks do not want to assume the same risk

260. The concern about liquidity takes two forms. First, there is the concern about yield liquidity in a stable market. While there are sufficient numbers of investors in the secondary market willing to purchase bonds issued in a CMBS transaction, from the perspective of these banks, the market is not yet large enough to provide the yield liquidity required by their investment criteria. For example, if a bank purchases a CMBS bond on day one and wants to sell the bond in the secondary market on day two, assuming no fluctuations in either interest rates or default rates that effect the value of the bond, the concern of the banks is that the CMBS bond yield, which should remain the same as it was when the bond was purchased, would fluctuate because the current size of the CMBS market is not large enough to maintain stable yield pricing. These institutions compare the AAA CMBS market to the more liquid Treasury market and Federal Agency market. However, both the Treasury and Federal Agency markets are deemed large enough to maintain stable yield pricing on the bonds issued.

Second, these banks are concerned about market value liquidity. Any change in the real estate market, whether national or within a region will influence both the current market value of the security and the liquidity of the security. If the banks were put into a position of requiring the capital that they invested in commercial mortgage backed securities at a time when the securities market value was depressed, then the investing banks would have to sell the security at a discount. The lack of yield stability and market value liquidity does not fit the investment philosophy of preservation and protection of capital required by these banks.

in their investment portfolio that they assume in their loan portfolio.

For these banks, the costs associated with developing the expertise to properly evaluate a CMBS investment, coupled with the default and liquidity risks of CMBS, are not worth the additional investment risk.

VIII. CONCLUSION

Although CMBS has become a viable lending strategy for First Union and NationsBank, CMBS has not yet become a viable investment strategy for medium- and small-sized banks. The likelihood that banks like BB&T, CCB, Centura, and Wachovia will invest in CMBS is minute. The conservative investment philosophy of these institutions combined with the availability of investments that offer sufficient return do not make CMBS investing plausible.

The development of CMBS demonstrates the adaptability of the law to facilitate new financing structures. With lending and legal infrastructures for CMBS established and the development of a secondary market that has accepted CMBS, Commercial Mortgage Backed Securitization is an additional source of commercial real estate financing.

However, the long term impact of CMBS remains unclear. The future success of CMBS depends upon the economic factors[261] that

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261. Mr. Brown of First Union and Mr. Rivkin of NationsBank offer differing views on the potential impact the economy and the marketplace will have on the future of CMBS. Brown's perspective is that the CMBS market will begin to face difficulties if the interest rates for ten-year Treasury obligations exceeds eight percent. Brown divides his market of potential borrowers into two main categories. First, there are those with real estate who need to refinance. Second, there are those with real estate who want to refinance, but who do not need to refinance.

The borrowers who need to refinance, need to do so for two possible reasons. Either, they have an existing loan with a balloon payment coming due, or they want to do additional commercial real estate development and need the equity in their existing property to finance that additional development.

Borrowers who want to refinance but who do not need to refinance are motivated either by the current interest rate environment (offering the borrower a lower interest rate than their existing loan) or by large amounts of equity in property that they want to realize. The likelihood that potential borrowers will refinance is closely tied to prevailing interest rates. Those borrowers who need to refinance, while still keenly aware of interest rates, are also motivated by factors outside the interest rate calculation.

Brown believes that if the interest rates of ten year Treasury obligations exceed eight percent, then there may be a concomitant chilling effect on the segment of the commercial real estate market that wants to but does not need to refinance. For example, if a CMBS lender's target is to offer interest rates to its borrowers at 250 basis points over a ten year Treasury obligation that had a 8.5% interest rate, then that would correspond to determine whether CMBS is a worthwhile investment, rather than upon legal factors. Although potential pitfalls exist, CMBS has quickly become an important alternative to traditional sources of financing in commercial real estate.

ALAN KRONOVET†

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an 11% CMBS interest rate. Since loans for securitization often have prepayment penalties and prepayment lockout periods, an 11% interest rate for 10 years would present a large long-term debt service burden on most commercial real estate property. Due to the potentially large long-term debt service burden, CMBS loan origination might slow down. Those borrowers who do not need loans are not likely to refinance. If that segment of the potential pool of borrowers is removed, then the issuance of commercial mortgage backed securities may also diminish.

Rivkin believes that market competition between lenders may create difficulty for the CMBS market. Rivkin feels that, when traditional commercial real estate lenders begin to view CMBS as a serious competitive threat to their commercial real estate lending business, they will respond in such a way as to make CMBS lending less attractive to the borrower. One possible response would be a change in lending interest rates that would require CMBS lenders to lower their interest rates. This decline in interest rates would be reflected in diminished returns for potential investors in commercial mortgage backed securities. Clearly, the lower the return for the potential investor, the less favorable an investment CMBS becomes.

The concerns raised by both Brown and Rivkin reflect the importance of loan origination in CMBS. If there is an insufficient volume of loans originated, then there will be a paucity of commercial mortgage backed securities available for purchase by investors.

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